FRBSF Weekly Letter

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Stormy Weather

In the four years after the "Crash" in October 1929, prices fell by 25 percent and national income almost one-half (30 percent in "real" or inflation-adjusted terms), while unemployment soared from 1.5 to 13 million, or 24 percent of the labor force. In addition, over 9,000 banks failed — almost 40 percent of the nation's total.

This *Letter* provides an overview of developments during the turbulent decade of the 1930s, including the controversial role of monetary policy. It also discusses the profound changes in the Federal Reserve's structure and powers that were enacted by the Congress, together with laws affecting the structure and powers of banks, that were designed to rectify many of the problems believed to have contributed to and exacerbated the Great Depression.

Two pots for every chicken

The causes of the Great Depression still are a matter of considerable debate among economists. Many, such as Milton Friedman, argue that "prevention or moderation in the decline of the stock of money . . . would have reduced the contraction's severity and almost certainly its duration." However, Friedman also notes that "as events unfolded, the decline in the stock of money and the near collapse of the banking system can be regarded as a consequence of nonmonetary forces in the United States and monetary and nonmonetary forces in the rest of the world," and that, even with a more expansive monetary policy, "the contraction might still have been relatively severe."

Observers who have emphasized the latter view include Marriner Eccles, the Utah banker appointed Governor of the Federal Reserve Board by President Roosevelt in 1934. He argued that consumption spending simply had failed to keep pace with production during the 1920s. This, along with the enormous diversion of funds to the stock market and the weakness in the farm sector, led to a fundamental imbalance in the economy.

A record peacetime tax increase in 1932 to help balance a $5 billion budget, together with tax increases at the state and local government levels, also exerted a strong contractionary effect upon private spending. Finally, enactment of the Smoot-Hawley tariff in 1932, which raised tariffs to the highest levels in the nation's history, wreaked havoc on international trade. The tariff made it difficult for foreign nations to earn dollars to buy American products and to repay their substantial World War and post-war borrowings from the U.S., leading in turn to widespread defaults.

The Depression had many causes, but few would argue that the demise of nearly 40 percent of the nation's banks and an attendant 35 percent net decline in the money supply were major factors contributing to its severity. As one Fed historian later noted, records of policy discussions, Congressional testimony and published reports indicate that Fed officials had a pretty good grasp of unfolding business and financial developments, but to some extent felt a correction for the speculation of the 1920s was inevitable. For some time, they did not "anticipate the severity . . . of the developing financial crisis."

Brother can you spare a dime?

Following the stock market Crash, Reserve Banks tried to give the economy a boost by progressively cutting (from 6 percent at the New York Fed to 2½ percent in mid-1930 and to 1½ percent a year later) the discount rate — the rate at which member banks could borrow from the Fed. Many banks, however, feared that borrowing from the Fed would be interpreted by depositors as a sign of weakness. Reserve Banks even helped member banks *reduce* their borrowings by purchasing moderate amounts of U.S. government securities. As a result, borrowings dropped from over $950 million at the time of the Crash to just under $100 million at the end of 1933.

In September of 1931, devaluation of the English pound raised concerns that a drop in the dollar's value would follow. The Reserve Banks reacted by sharply raising discount rates (from 1½ percent to 3½ percent at the New York Fed) and keeping the rates at the higher levels for almost five months in an effort to stem an outflow of gold (which backed the currency).

Due to the sharp drop in borrowing through the Reserve Banks' discount windows, member bank reserves over the entire period from the Crash to the end of 1933 rose by only about $400 million (17 percent), and this in response to a net increase in System purchases and holdings of government securities from $165 million to $2.4 billion.

Moreover, due to a scramble for liquidity on the part of the public through deposit withdrawals, and on the part of banks themselves, which chose to hold and increase rather than lend and invest excess reserves, commercial bank loans and investments declined by about 35 percent and were accompanied by a comparable reduction in the money supply. Absent these developments, the increase in Fed "high powered money" (member bank reserves and currency in circulation) would have resulted in about a 17 percent net *increase* in the money supply.

New powers and structural reforms . . .
The severity of the Depression brought forth — belatedly — a spate of legislation designed to rectify perceived failings in the banking and financial structure and to strengthen materially the Fed's ability to deal with the problems that had developed. In 1932, legislation was passed to enhance the System's ability to conduct open market operations. It allowed U.S. government securities as well as gold and "eligible" commercial paper to be used as collateral for Federal Reserve Notes, thus easing the constraints of the gold cover-eligible paper requirement. Member banks also were permitted to borrow from the Reserve Banks on any "sound asset" rather than just on short-term, "self-liquidating" paper.

The Banking Act of 1933 gave the Reserve Banks power to vary member bank reserve requirements within legally specified minimum/maximum ratios, and also authorized them to lend to nonmember banks and other entities under "unusual and exigent circumstances (since eighty percent of the banks that failed since 1929 were nonmembers)." Member banks were prohibited from engaging in investment banking, including the underwriting and purchase of stocks for their own portfolios. And, in the wake of the massive bank failures, compulsory federal deposit insurance was instituted for federally chartered banks and savings and loan associations. In 1934, the Securities and Exchange Commission was established and the Fed was given authority to set stock-margin requirements.

Increased independence . . . and centralization
The Banking Act of 1935 mandated other sweeping changes in the structure and operating procedures of the System. The Federal Reserve Board was renamed the "Board of Governors" and its Chief Executive Officer, "Chairman." The Chief Executive Officers of the Reserve Banks were renamed "President" (rather than "Governor"), and their appointment made subject to approval by the Board of Governors.

To better insulate the Board from political pressure from the Executive Branch, the Treasury Secretary and Comptroller were removed from *ex officio* membership, and Board members' terms were increased to 14 years. Carter Glass cited his own actions, as well as those of other Treasury Secretaries, as evidence that "the Federal Reserve System is used in an unwise way by the Treasury and under the dominance of the Secretary of the Treasury."

Most important, the Open Market Committee, which determined the Fed's open market sales and purchases of securities, was completely revamped by centralizing control in the Presidentially appointed Board of Governors. The Committee was reconstituted to include the seven-member Board and five of the Reserve Bank Presidents, the latter to serve in a voting capacity on a rotating basis except for permanent membership by the President of the New York Fed.

Congress rejected Chairman Eccles' efforts to amend the Federal Reserve Act to provide a more specific policy guide than simply "accommodating commerce and business," which he considered a "glittering generality." Eccles favored making it the "duty" of the Board "to promote conditions conducive to business stability and to mitigate . . . unstabilizing fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action." He emphasized the dominant influence on economic activity of the money supply *and* its rate of utilization (velocity), but argued that policymakers also "have to take into account factors other than purely the mathematical or mechanical factors of money."

Differing views

As in 1913 when the Federal Reserve was created, many bankers viewed the reforms with considerable hostility. Whereas California's A. P. Giannini strongly supported the proposed reforms, a number of his East Coast contemporaries considered them "instruments of despotic authority" and even a step towards Communism. Representative of the latter view was New York banker James Warburg, who was unhappy not only with the proposed reforms but with Chairman Eccles "Keynesian" analysis of the role of the money supply and the rate of its expenditure in influencing the volume of business activity. For its part, the American Bankers *Journal* (July 1933) argued that "the guaranty (insurance) of bank deposits violates every conception of a capitalistic society (and) will not work."

Some voices were quite strident. Prior to his defeat in the 1934 election, Congressman (and banker) Louis McFadden (R-PA) first tried to impeach President Hoover, and then the Federal Reserve System, for "high crimes" including theft on behalf of its alleged "masters" — Great Britain and the "international bankers". Various "shirtists" hurled their barbs, while "Radio Priest" Charles Coughlin demanded "Honest Money," and denounced the "Shylocks" of the Federal Reserve as tools of the "prophets of evil" — the Warburgs and Rothschilds.

Darkness at noon

Following a fairly vigorous recovery which commenced in 1934, the economy again slipped into a recession in 1937, with unemployment rising to 19 percent from 14 percent. The downturn was widely attributed to the imposition of an excess profits tax and an increase by the System in member bank reserve requirements to their legal maxima. The Fed's actions resulted from concern over rising prices (wholesale prices rose about 7 percent in 1937) and the inflationary potential of a soaring volume of bank excess reserves, which exceeded the level that could be absorbed by open market sales of U.S. governments from the System's portfolio.

As a result of the downturn, the excess profits tax was repealed and reserve requirements were reduced. The economy again moved upward, and, under the impact of soaring gold inflows and an increasingly war-nervous Europe, member banks' *excess* reserves rose to over $6 billion by the end of 1939 — almost matching the volume of required reserves.

Conclusion

The decade of the 1930s witnessed unparalleled peacetime intervention by the federal government in the nation's economic life not only through an expanding budget but through laws and regulations affecting virtually every sector of activity. In 1939, real GNP finally recovered to its 1929 level, but unemployment still amounted to 17 percent of the labor force. Moreover, in the view of many observers, the expansionary effects of government spending, which at its peak was only one-half the level attained in World War I, had been offset to a very considerable extent by rising taxes at the state and local government levels.

In April 1939, the Board of Governors reaffirmed to the Congress the *System's* objective — not yet formalized by the Congress — of helping to achieve "the fullest practicable realization of the country's human and natural resources." But it also noted that "since the money supply, however measured," was at record levels, the difficulty of achieving its objective "must not be in the scarcity but in the inadequate use of the existing supply" (at this time, the discount rate was 1 percent and the short-term T-bill yield only .02 percent). It added that "there are many phases of economic life that are not susceptible of control through money means alone."

The role of the "velocity" of money and the proper consideration that should be given to factors other than money was to remain at the core of debate among economists and policymakers decades later. However, as the decade of the Thirties came to an end, it was gathering war clouds in Europe and Asia that would again shape the course of the economy — and monetary policy.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/26/86	Change from 2/19/86	Change from 2/27/85 Dollar	Change from 2/27/85 Percent[7]
Loans, Leases and Investments[1 2]	200,710	– 153	12,039	6.3
Loans and Leases[1 6]	181,658	– 130	10,579	6.1
Commercial and Industrial	52,409	318	– 413	– 0.7
Real estate	66,298	– 31	3,898	6.2
Loans to Individuals	38,547	23	5,777	17.6
Leases	5,672	8	396	7.5
U.S. Treasury and Agency Securities[2]	10,846	36	219	2.0
Other Securities[2]	8,206	– 58	1,240	17.8
Total Deposits	198,327	–3,126	5,766	2.9
Demand Deposits	46,118	–2,853	2,430	5.5
Demand Deposits Adjusted[3]	31,006	– 228	2,993	10.6
Other Transaction Balances[4]	14,767	– 220	1,972	15.4
Total Non-Transaction Balances[6]	137,441	– 54	1,363	1.0
Money Market Deposit Accounts—Total	45,790	– 17	2,007	4.5
Time Deposits in Amounts of $100,000 or more	38,016	41	– 1,158	– 2.9
Other Liabilities for Borrowed Money[5]	25,166	426	4,756	23.3

Two Week Averages of Daily Figures	Period ended 2/24/86	Period ended 2/10/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	71	81
Borrowings	191	10
Net free reserves (+)/Net borrowed(–)	– 119	71

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change